Amendments to the Federal Reserve Act

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THE Federal Reserve Act has been amended a number of times since it became a law on December 23, 1913, but none of the amendments can be said to have affected any fundamental change in the structure or operation of the Federal Reserve System. Experience has indicated how the purposes of the framers of the Act could be advanced by further legislation, and how the Federal Reserve System could best serve the banks and the business of the country; Congress in the light of this experience has modified many of the provisions of the original Act. But the principles upon which the Act was based, the functions of the Federal Reserve Banks and their relation to the member banks and to business and commerce, remain essentially unchanged. It will not be attempted in this chapter to discuss every amendment, for many of them are not considered of sufficient general interest to warrant mention in a work of this character; in many cases they relate solely to the internal administration of the Federal Reserve Banks.[1]

ACCEPTANCE POWERS OF NATIONAL BANKS

The first important amendment was the Act of September 7, 1916. Probably the most far reaching change effected by this amendment was with respect to the acceptance powers of national banks. The Act, as originally passed, authorized member banks to accept only drafts and bills of exchange "growing out of transactions involving the importation or exportation of goods." National banks were without authority to accept drafts in domestic transactions until, by the Act of September 7, 1916, they were given authority to accept drafts or bills in transactions involving the domestic shipment of goods or the storage of readily marketable staples, subject to certain prescribed conditions.

These conditions were that the bank issuing acceptances in such domestic transactions must be secured at the time of acceptance by shipping documents covering the goods in process of shipment, or by warehouse receipts or other similar documents covering the readily marketable staples in storage. There never has been any similar requirement of law with respect to acceptances in foreign transactions and it is important to note this distinction, for it is the basis for a more liberal practice in connection with the issue of foreign acceptances than has been adopted with respect to domestic acceptances.

Because of the requirement that documents representing the goods or staples must be in the possession of the accepting bank at the time of acceptance, it is obviously impossible that domestic acceptances be issued except when the goods or staples are identified and in process of shipment or in storage. The issuance of acceptances to finance foreign transactions has, however, been authorized prior to the commencement of the actual export or import shipment, in cases where the customer for whom the acceptances are issued is under a definite contract to export or import goods in the future. This has been authorized upon the

[1] For a complete list of amendments prior to January 1, 1921, see the Annual Report of the Federal Reserve Board for the year 1920, pages 316–326.

theory that the export or import transaction commences with the execution of the contract and that the subsequent acts in fulfilment of that contract are inherent parts of that transaction, and may, therefore, be financed by means of acceptances.

The Act of September 7, 1916, further broadened the authority of national banks to issue bankers' acceptances by permitting them, under regulations of the Federal Reserve Board, to accept ninety day drafts or bills drawn by banks or bankers in foreign countries or dependencies or insular possessions of the United States for the purpose of furnishing dollar exchange as required by the usages of trade in those places. Under the authority of this amendment the Federal Reserve Board has granted permission to member banks applying therefor to accept ninety day dollar exchange drafts drawn by banks or bankers in South American countries and in dependencies and insular possessions of the United States.

OTHER PROVISIONS OF THE AMENDMENT OF SEPTEMBER 7, 1916

Another important feature of the Act of September 7, 1916, was that it authorized Federal Reserve Banks to make advances for fifteen days to member banks on the promissory notes of the member banks when such notes are secured by paper which is eligible for rediscount or purchase or by bonds or notes of the United States. The provisions of the original Act did not permit Federal Reserve Banks to make advances or loans but permitted them only to rediscount eligible paper previously discounted by member banks.

The Act of September 7, 1916, amended Section 25 of the Federal Reserve Act so as to authorize national banks with a capital and surplus of not less than $1,000,000 to invest in the stock of foreign corporations. This amendment will be referred to in connection with the amendments of September 17, 1919, and December 24, 1919, which deal with the same general subject matter.

AMENDMENT OF JUNE 21, 1917

The second important amendment to the Act was that of June 21, 1917. Up to this time few state banks had joined the Federal Reserve System, largely because, by becoming members under the provisions of Section 9 of the original Act, they were made subject to the provisions of the National Bank Act, which prohibit national banks from making loans to any one person in excess of 10 per cent of the bank's capital and surplus, and were required to make reports of condition to the Comptroller of the Currency; also because Section 21 of the original Act required the Comptroller to examine state member banks at least twice a year. The argument was also made that under the terms of the original Act a state bank once having joined the Federal Reserve System had no right to withdraw. In order to make membership in the System more attractive to state banks and trust companies, Section 9 was rewritten. This section as it now reads exempts state bank and trust company members from supervision or examination by the Comptroller of the Currency and provides that "subject to the provisions of this Act and to the regulations of the board made pursuant thereto, any bank becoming a member of the Federal Reserve System shall retain its full charter and statutory rights as a State bank or trust company, and may continue to exercise all corporate powers granted it by the state in which it was created." It also contains a provision specifically authorizing

withdrawal from membership upon six months' notice.

The Act of June 21, 1917, also amended the first paragraph of Section 13 of the Act so as to authorize non-member banks, irrespective of whether their capital is sufficient to make them eligible for full membership, to clear through the Federal Reserve Banks of their districts checks deposited with them, provided that they maintain balances with such Federal Reserve Banks sufficient to offset the items in transit held for their accounts. While this privilege has not been availed of by non-member banks to any material extent, apparently because non-member banks are able to obtain the full benefits of the Federal Reserve check clearing facilities by sending checks deposited with them to correspondent member banks which in turn clear such checks through their Federal Reserve Banks, and while from a strictly legal standpoint the Act of June 21, 1917, in the form in which it was finally enacted, did not have any important bearing upon the check clearing and collection functions of Federal Reserve Banks, nevertheless a brief discussion of the subject of check clearing and collection seems appropriate at this point because it was discussed at length in both the Senate and the House of Representatives when Congress had the preliminary drafts of the bill under consideration, and because the provision added by this Act at the end of the first paragraph of Section 13 is frequently referred to in discussions relative to this general subject.

Legal Aspect of the Federal Reserve Clearing System

In July, 1916, a country wide Federal Reserve check clearing and collection system was instituted, each member bank being required to remit at par for all checks drawn upon it cleared through the Federal Reserve Banks. This was an inter-district as well as an intra-district system, the exclusively intra-district clearing systems, which had previously been established but membership in which had been optional with each member bank, having proved unsatisfactory. Simultaneously with the establishment of the country wide clearing system, the Federal Reserve Bank of Boston took over the country collection department of the Boston Clearing House and was able to collect checks on all banks in New England at par, that is, at the full face amount without the deduction of any exchange charge by the drawee banks. In the other districts it was not possible to collect at par checks drawn on all non-member banks because many of them desired to continue their past practice of charging exchange when remitting for their checks. From the first, however, it was contemplated that the Federal Reserve check clearing and collection system should be extended gradually until it furnished facilities for collecting at par checks on all banks in the country, thus eliminating the enormous tax with which business and commerce has been burdened by reason of the practice of making exchange charges.

In their origin there was some justification for exchange charges because such a charge then represented an actual expense which the remitting bank incurred in having currency transported from where the bank was located to the place of business of the holder of the check who had received it in payment of a debt. At the present time, however, there is no necessity for the actual transportation of currency between Federal Reserve districts, since the Federal Reserve System, through its leased wires connecting all Federal Reserve Banks and

branches and through its Gold Settlement Fund at Washington, offers facilities for the instantaneous transfer of available funds by mere book entry. The Federal Reserve System pays the entire cost of maintaining these leased wires and the Gold Settlement Fund, and the Federal Reserve Banks pay the cost of transporting currency from member and non-member banks in their districts if such member or non-member banks desire to make remittances for their checks in this manner. Consequently, the justification for exchange charges has ceased to exist and to the extent that such charges are still made they constitute a tax paid by business and commerce for which no compensating service is received.

Following the policy of extending the Federal Reserve check clearing and collection system the Federal Reserve Banks undertook to induce non-member banks to remit to them at par, and when able to make satisfactory arrangements, they also undertook to collect checks drawn on non-member banks which did not remit at par by having such checks presented at the counters of the drawee banks.

This practice caused some opposition on the part of the non-member banks which still desired to charge exchange and as a result of this opposition a provision was inserted in the bill pending in Congress in the spring of 1917 to the effect that nothing in the Federal Reserve Act should be construed as prohibiting a member or non-member bank from making reasonable exchange charges. The Senate passed the bill with this provision in it, but the sentiment in favor of par collection finally prevailed and in the bill as agreed to in conference between the committees of the Senate and the House, and in the Act as finally approved, this particular provision was in effect nullified by the addition at the end of the paragraph in question, the first paragraph of Section 13, of the following clause: "but no such charges shall be made against the Federal Reserve Banks."

The policy of extending the Federal Reserve check clearing and collection system has been continued until now Federal Reserve Banks are able to collect checks drawn on about 28,000 out of a total of approximately 30,000 banks in the United States. The claim is made by some non-member banks which still persist in their desire to charge exchange when remitting for checks, that the final clause of Section 13 of the Federal Reserve Act should be construed as prohibiting Federal Reserve Banks from undertaking to make counter presentation of checks drawn on non-member banks which have not agreed to remit at par to the Federal Reserve Banks and this issue is involved in suits which have been instituted by such non-member banks against several of the Federal Reserve Banks.

AMENDMENT OF RESERVE REQUIREMENTS

Another important amendment accomplished by the Act of June 21, 1917, was the amendment to Section 19 of the Act changing the character and amount of the required reserves of member banks.

Section 19 of the Federal Reserve Act as amended by the Act approved August 15, 1914, before the Federal Reserve System was put into actual operation in November, 1914, provided that member banks in central reserve cities should maintain reserves equal to 18 per cent of their demand deposits and 5 per cent of their time deposits, and that member banks in reserve cities should maintain reserves equal to 15 per cent of their demand deposits

and 5 per cent of their time deposits, and that other member banks should maintain reserves equal to 12 per cent of their demand deposits and 5 per cent of their time deposits. Each class of member banks was required to keep only a part of its reserves in the form of balances with Federal Reserve Banks, another part being kept in the vaults of the member banks, and the member banks being given the option to carry the remainder either in their own vaults or as balances. This being the state of the law, a large proportion of the gold supply of the country remained in the vaults of member banks, where it constituted a part of the banks' lawful reserves.

The purchases in this country by the belligerent nations resulted in rapid accretions to this nation's gold supply and made it seem desirable to have a more effective means of controlling a possible over-extension of loans based upon these new accretions. On the other hand, the possibility of the rapid outflow of this gold at some time in the future made it necessary to provide for the most effective use of the gold supply, so that withdrawals might be arranged without forcing any violent contraction of loans and without causing any undue disturbance to legitimate business. For the accomplishment of these ends the mobilization and concentration of gold in the Federal Reserve Banks seemed the most effective means.

The first legislative move in this direction was the addition by the Act of September 7, 1916, of subsection 11(m) of the Federal Reserve Act providing that the Federal Reserve Board may permit member banks to carry in their Federal Reserve Banks any portion of their reserves theretofore required by Section 19 of the Federal Reserve Act to be carried in their vaults. When this country became directly involved in the War the question of the mobilization of the gold reserves of the country became still more important and was the primary cause of the enactment of the Act of June 21, 1917. By this Act member banks were required to maintain the entire amount of their reserves in the form of balances with Federal Reserve Banks, the total reserves required against demand deposits being reduced to 13, 10 and 7 per cent for member banks in central reserve cities, reserve cities, and country districts, respectively, and the total reserves required against time deposits being reduced to 3 per cent for all member banks.

TRUST POWERS OF NATIONAL BANKS

After June, 1917, the Federal Reserve Act was not amended until September 26, 1918. This Act effected changes in a number of sections but the only one of general importance was the revision of Section 11 (k) relative to trust powers by national banks.

Under this section in its original form the Federal Reserve Board was authorized merely to grant to national banks "when not in contravention of state or local law, the right to act as trustee, executor, administrator, or registrar of stocks and bonds." National banks opening up trust departments, in accordance with authority granted to them pursuant to this section, were limited to the exercise of the four powers specifically enumerated, although competing state banks and trust companies might be permitted to exercise other fiduciary powers. Furthermore, the laws of some states specifically, or by necessary implication, prohibited the exercise of any fiduciary powers by national banks, so that it was "in contravention" of state law for national banks to exercise such powers, although competing state

banks might do so under the laws of the state. It became more and more apparent that national banks were laboring under a serious handicap in their competition with state institutions in the exercise of trust powers, and the amendment of September 26, 1918, was designed to put national banks upon equal terms with competing state institutions.

To this end the section was amended so as to include among the powers which the Federal Reserve Board could grant, the power to act as guardian of estates, assignee, receiver, committee of estates of lunatics, or in any other fiduciary capacity in which competing state banks are permitted to act. A provision was also inserted to the effect that whenever the laws of a state permit the exercise of fiduciary powers by competing state corporations, it shall not be deemed to be in contravention of state law for national banks to exercise such powers. Various other provisions were inserted to insure competition upon equal terms between national banks and competing state corporations, including that contained in the final paragraph of the section as amended to the effect that no permit shall be issued to any national bank having a capital and surplus less than the capital and surplus required by state law of state institutions exercising fiduciary powers.

The constitutionality of the original Section 11 (k) was upheld by the Supreme Court of the United States in the case of *First National Bank* v. *Union Trust Company*, 244 U. S. 416, in which it was held that Congress had power to grant to national banks authority to act in fiduciary capacities. The construction of Section 11 (k) as amended has been involved in a number of more recent suits. These suits have established that it is beyond the power of any state legislature to discriminate against national banks by prohibiting such banks from exercising fiduciary powers and that it makes no difference whether such discrimination is attempted by an affirmative prohibition against the exercise of fiduciary power by national banks or by withholding from the courts the powers to appoint national banks in fiduciary capacities.

DISCOUNT LIMITATION ON SINGLE BORROWER

The Act of March 3, 1919, amending the Federal Reserve Act, was of importance to member banks because it substituted for the then existing Section 11 (m), which had become obsolete, a new Section 11 (m), authorizing the Federal Reserve Board to permit Federal Reserve Banks to discount for member banks the paper of a single borrower up to 20 per cent of the member bank's capital and surplus, provided that the paper is secured by United States bonds or notes issued since April 24, 1917, or by United States certificates of indebtedness. Under the terms of Sections 9 and 13 the amount of paper of any one borrower which a Federal Reserve Bank may discount for any one member bank is limited generally to 10 per cent of the member bank's capital and surplus.

Section 11 (m) was intended as a temporary measure to assist in the absorption by the investing public of the securities issued by the government during the War, and according to its terms the section ceased to be effective after December 31, 1920. This process of absorption was not deemed to have been completed by that date, however, and section 11 (m) was re-enacted with a slight modification by an Act of Congress approved February 27, 1921, to be effective until October 31, 1921.

FOREIGN BANKING AMENDMENTS

Acts were approved September 17, 1919, December 24, 1919, and June

14, 1921, all relating to the same general subject matter, namely, the investment by national banks in stock of corporations engaged in foreign banking and other international financial operations, and the organization and operation of such corporations under Federal law and subject to Federal supervision. After the close of the War it became apparent that the adequate financing of foreign trade would require credit facilities of a kind which could not properly be furnished by banks doing a strictly commercial banking business, and that such special facilities could be furnished in a large way only by corporations with authority to purchase foreign securities and paper representing long term credits, and with authority to issue and sell to the public their own debentures secured by such securities and long-term paper.

The Act of September 7, 1916, had amended Section 25 of the Federal Reserve Act so as to authorize the larger national banks, that is banks with capital and surplus of not less than $1,000,000, to invest in the stock of "banks or corporations . . . principally engaged in international or foreign banking." There seemed to be some doubt, however, whether this authority to invest in stock of banks or corporations engaged in banking gave the right to invest in stock of these debenture-issuing or investment corporations. Furthermore, it seemed desirable for the encouragement of such corporations to authorize investments in their stock by all national banks, both large and small. Consequently, the Act of September 17, 1919, was passed authorizing national banks until January 1, 1921, and without regard to the amount of their capital and surplus, to invest in the stock of corporations "principally engaged in such phases of international or foreign financial operations as may be necessary to facilitate the export of goods, wares or merchandise from the United States or any of its dependencies or insular possessions to any foreign country."

Section 25, as thus amended, in terms authorizes national banks, upon the conditions and subject to the limitations therein stated, to invest in the stock of banks or corporations, of the specified kinds, which are "chartered or incorporated under the laws of the United States or any State thereof"; but, as a matter of fact, no provision was made for the incorporation under Federal law of such banks and corporations until the enactment of the so-called Edge Act, approved December 24, 1919.

This Act added to the Federal Reserve Act a section, designated Section 25 (a), which authorizes the organization of corporations "for the purpose of engaging in international or foreign banking or other international or foreign financial operations," thus permitting the Federal incorporation of both types of corporations referred to in Section 25, that is, banks doing a commercial banking business, and corporations issuing debentures and doing an investment business. The Act also describes the powers of such banks and corporations and gives to the Federal Reserve Board full power to examine, supervise and regulate their operations.

Section 25 (a) as originally enacted required that corporations organized under it should have a capital of not less than $2,000,000, one-quarter of which must be paid in before the corporation is authorized to commence business, and the balance in ten per cent installments at the rate of one every two months. This requirement was modified by the Act approved June 14, 1921, which provides, in effect, that a corporation with an

authorized capital in excess of $2,000,000 may apply for the consent of the Federal Reserve Board that such excess be paid in on call of the board of directors, provided, that in all events 25 per cent of the total authorized capital must be paid in before the corporation commences business.

THE SLIDING SCALE AMENDMENT

Finally, the Act of April 13, 1920, should be mentioned. Subsection (d) of Section 14 of the Federal Reserve Act authorized every Federal Reserve Bank to establish, subject to review and determination by the Federal Reserve Board, rates of discount for each class of paper. The Act of April 13, 1920, added to this section language specifically providing that such rates "may be graduated or progressed on the basis of the amount of the advances and discount accommodations extended by the Federal Reserve Bank to the borrowing bank." The purpose of this amendment was, of course, to give to the Federal Reserve Banks and the Federal Reserve Board clear authority to require member banks habitually borrowing in excess of their legitimate requirements to pay higher discount rates for their excess borrowings.

Preparation for War and the Liberty Loans

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AT the entrance of the United States into the World War in 1917 the readjustment of our credit and financial system to meet the unusual demands of the Public Treasury devolved in a large measure upon the Federal Reserve Banks. The financial activities of the government were soon to be extended upon a scale never before equalled by any country and the financial resources of the country were to be assembled and directed toward one purpose, winning the War. To accomplish this purpose would require highly developed sales organizations which would extend to every county and village in the country, and elaborate machinery for distributing the securities and collecting and disbursing the funds according to the Treasury's needs. More fundamental, however, was the necessity that our banking system should be able to meet the enlarged demands for credit incident to war financing, without unduly curtailing the credit needs of commerce and industry.

PREPARATION FOR WAR BY RESERVE BANKS

The announcement of the entrance of the United States into the War, however, did not find the Federal Reserve Banks wholly unprepared to meet the new responsibilities. Precautions had been taken early in the year to maintain the Federal Reserve Banks in a strong condition with regard for the disturbed conditions of the world and the changing economic conditions in this country. This country, heretofore a debtor country, had become a creditor nation; gold was flowing in, and foreign securities were being marketed here in increased amounts so as better to permit belligerent countries to pay for heavy purchases of goods, purchases so heavy, in